MARSH JLT SPECIALTY

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Transactional Risk Insurance 2019: Year in Review

MARSH

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INTRODUCTION

This edition of *Transactional Risk Insurance: Year in Review* comes at a fraught moment in time as the world responds to the COVID-19 pandemic.

The report looks back at the market in 2019, which marked the sixth straight year that global M&A value topped $3 trillion, although that was down slightly from the prior year. At the same time, the amount of transactional risk insurance placed by Marsh JLT Specialty increased significantly.

People and business alike face great uncertainty in 2020. How COVID-19 will affect M&A activity, and consequently the transactional risk insurance market, is difficult to predict at this point in time. Given the correlation between M&A overall activity and the use of transactional risk insurance, it's logical we should expect the growth trajectory will be interrupted.

M&A Snapshot

The value of global mergers and acquisitions (M&A) in 2019 was roughly US$3.3 trillion across 19,322 deals, down 6.9% from 2018 (see Figure 1). This represents the sixth consecutive year of deal values in excess of US$3 trillion, and overall deal value higher than both 2016 and 2017. Private equity buyout activity was robust, nearly matching 2018 levels, with buyouts valued at US$556 billion[1].

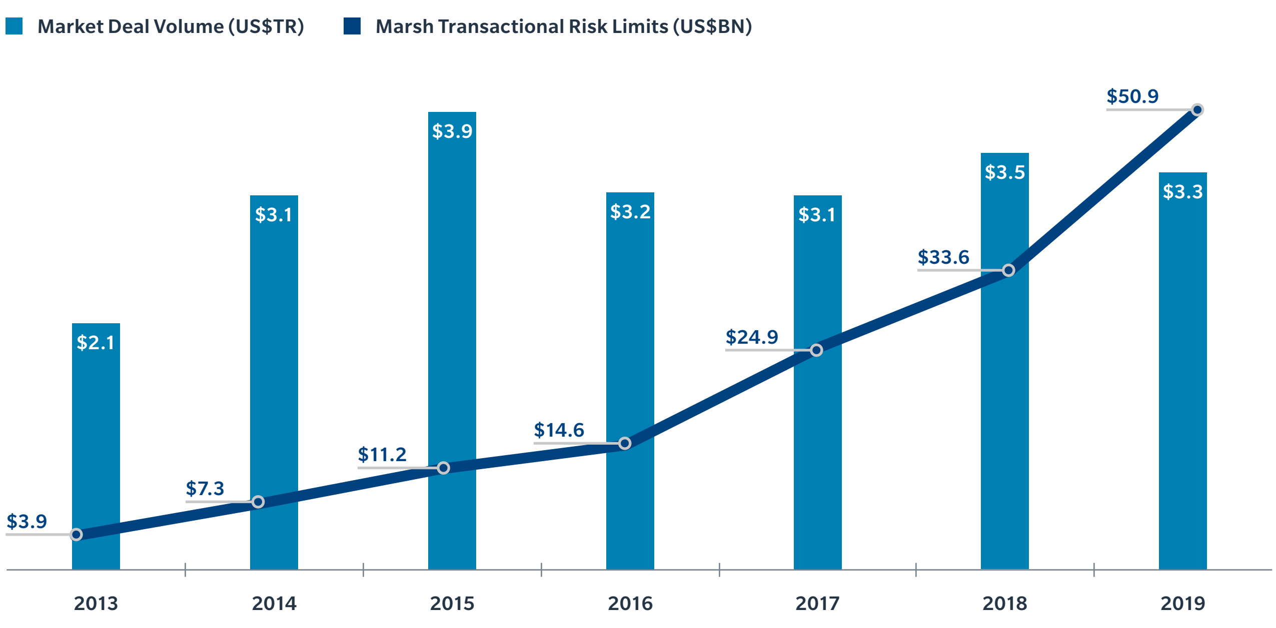
The combination of persistently low interest rates, strong strategic investor balance sheets, responsive credit markets, and ample uninvested funds from private equity firms led to fierce competition for assets. As private equity firms look for ways to deploy capital, take-private deals reached the highest levels in over a decade, totaling $158 billion in 2019.

The placement of transactional risk insurance globally by Marsh JLT Specialty in 2019 was marked by accelerated growth, with substantial increases in both aggregate limits placed, up 51%, and the number of insured transactions, up 26%. Increased use of transactional risk insurance is evidenced by the substantial growth in the face of a moderately declining deal environment. This widespread adoption of these products spans both private equity and strategic investors, as they represented 52% and 48% of placed limits, respectively.

FIGURE 1

Global M&A value tops $3 trillion for sixth straight year.

SOURCE: MARSH JLT SPECIALTY



1 Mergermarket

Global Trends

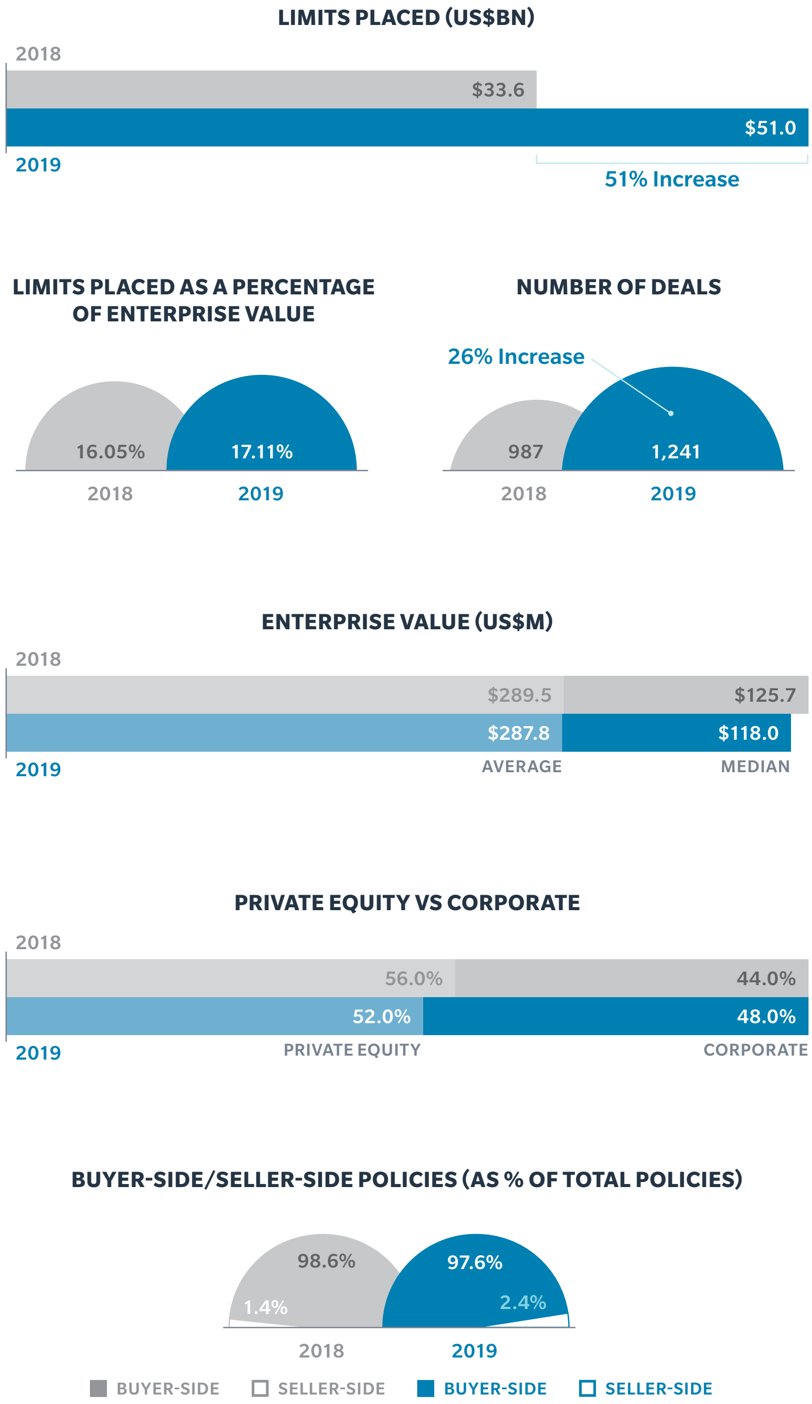
Transactional risk insurance includes policies that cover risks related to M&A, such as representations and warranties (R&W) insurance, or warranty and indemnity (W&I) insurance, tax insurance, and contingent liability insurance. Transactional risk insurance limits placed globally by Marsh JLT Specialty increased in 2019 by 51% from 2018, to US$50.9 billion (see Figure 2). These limits were spread over 1,241 closed transactions — an increase of 26% from the prior year.

Transactional risk insurance capacity continued to expand in 2019 with more than 30 insurers offering primary terms for coverage globally. Overall capacity now supports limits in excess of US$1 billion for a single transaction.

FIGURE 2

Transactional risk insurance limits placed by Marsh JLT Specialty increased 51% year-over-year.*

SOURCE: MARSH JLT SPECIALTY



* Please note: Figures used in this report refer to Marsh JLT Specialty business unless otherwise noted.

Regional Trends

North America

In 2019, the transactional risk insurance market remained robust in North America, with insurer capacity exceeding $1 billion in limits for a single transaction and more than 20 insurers offering terms on a primary basis.

Transactional risk insurance limits placed by Marsh JLT Specialty in the US and Canada grew to $19.6 billion in 2019, a 42% increase over 2018. The number of polices placed increased by 28%, to 851, while the number of closed transactions increased by 30%, to 526.

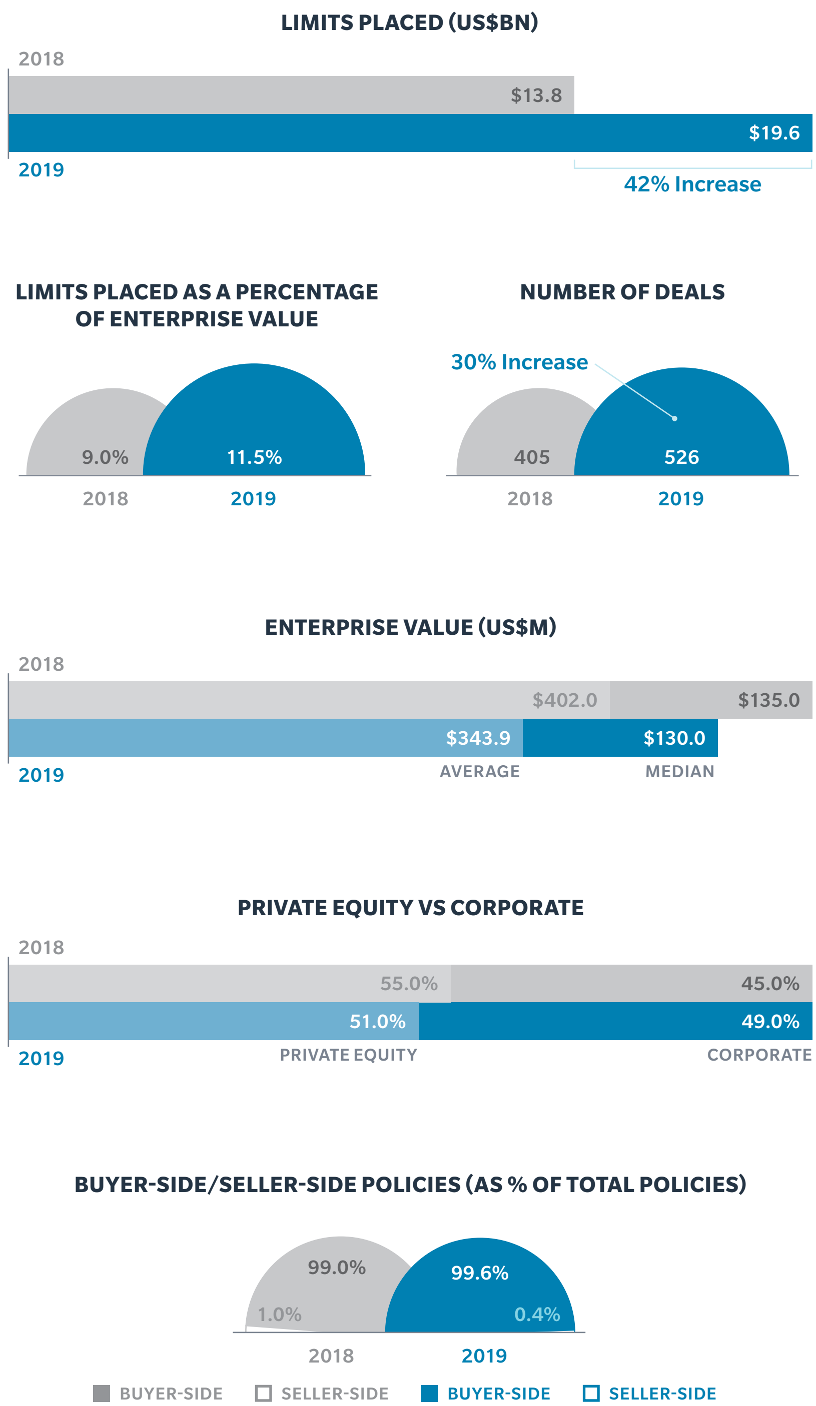
Market competition continued to drive a favorable premium rate environment for insureds during the majority of the year, with primary layer representations and warranty (R&W) premium rates declining by 11% from 2018, and down 34% from 2015. We anticipate that primary layer pricing will increase slightly in 2020, resulting from adverse claims activity, though tempered by robust competition in the market.

While rates continued to decrease in 2019, other key terms remained similar to 2018. Private equity firms continued to represent the majority of insureds in transactions placed in the region during 2019 — approximately 51% of policies. Still, the trend of corporate/strategic buyers increasing their use of transactional risk insurance continued in 2019, and we expect it to continue in 2020 and beyond.

FIGURE 3

North American transactional risk insurance market remains robust.

SOURCE: MARSH JLT SPECIALTY



Notable trends in 2019

Deductibles: Deductibles held steady at approximately 1% of enterprise value for most transactions, with a dropdown feature to 0.5% of enterprise value at the 12-month anniversary of closing. On larger transactions (those with enterprise value in excess of $500 million), it is common for the deductible to be 0.75% of enterprise value or less, with the same dropdown feature.

No seller indemnity structures: The aforementioned rate and deductible figures apply to transactions whether or not there is seller indemnity in the purchase agreement. Deals with a "no seller indemnity" structure grew in 2019 to represent approximately 41% of Marsh JLT Specialty's transactions in the region, up from 30% of transactions in 2018.

Transaction size vs. limits purchased: The average enterprise value per insured transaction in North America fell by 14% in 2019 to $344 million, as growth in the lower middle market segment — transactions of less than $100 million enterprise value — outpaced growth in the large transaction segment — transactions of $1 billion or more enterprise value. Despite the reduction in average enterprise value per transaction, clients insured a slightly larger portion of transaction value in 2019. On average, insureds purchased limits equaling 12% of the transaction size after this figure remained around approximately 9% for several years.

Tax insurance: Demand for tax insurance increased dramatically in 2019 in the North American market. Tax insurance limits placed by Marsh JLT Specialty in 2019 grew by more than 150%. The number of polices placed increased by 200% year-over-year, using 15 tax insurers, reflecting the expansion of underwriters into this sector of the transactional risk marketplace. While over 40% of transactions placed related to M&A activity, the majority of limits placed were in the renewable energy sector — with 40% of these deals and limits relating to investment tax credits and production tax credits — and "balance sheet tax risk management." As awareness of its effectiveness increases, we expect the market for tax insurance will continue to grow alongside M&A and in other contexts throughout 2020.

Claims: With the growth in the number of transactional risk policies placed over the past several years has come a corresponding increase in the number of claims reported to insurers. We expect this trend to continue, and perhaps accelerate, in the coming years. In 2019, R&W carriers' claims payments to Marsh JLT Specialty clients in the region exceeded $100 million.

Latin America

There continues to be increased investor interest throughout the region in transactional risk solutions. Marsh JLT Specialty has placed policies for assets located in Brazil, Colombia, Mexico, Argentina, and Guatemala and received quotes for deals in Chile, Peru, and Costa Rica. More than 10 insurers have demonstrated some interest in providing capacity in the region. Insurer appetite is deal- and country-specific. Premium rates typically are significantly higher than in other geographic regions, at 3% to 5%, and underwriting costs are also higher, often $50,000 or greater per transaction. Policies placed in the region typically contain more exclusions than those placed in North America, limiting their appeal and utilization. We anticipate insurer appetite for Latin America transactions to increase in the coming years, with increased competition leading to more insured-friendly terms on policies placed in the region.

EMEA

In 2019, the number of M&A deals and overall deal value in Europe decreased, although W&I insurance placed by Marsh JLT Specialty grew by about 24% over 2018.

The total insurance limit placed in 2019 increased by about 57% to $25.3 billion, driven by two key trends. First, the number of large deals insured — those valued at greater than $1 billion enterprise value — increased. Second, the "seller friendly" M&A market observed in many EMEA jurisdictions brought an increase in the number of sellers offering no recourse for title and capacity warranties, though this is still a minority of transactions. In such situations buyers have turned to the insurance market for protection and purchased cover for title and capacity warranties equating to the full transaction value, driving the total limit higher.

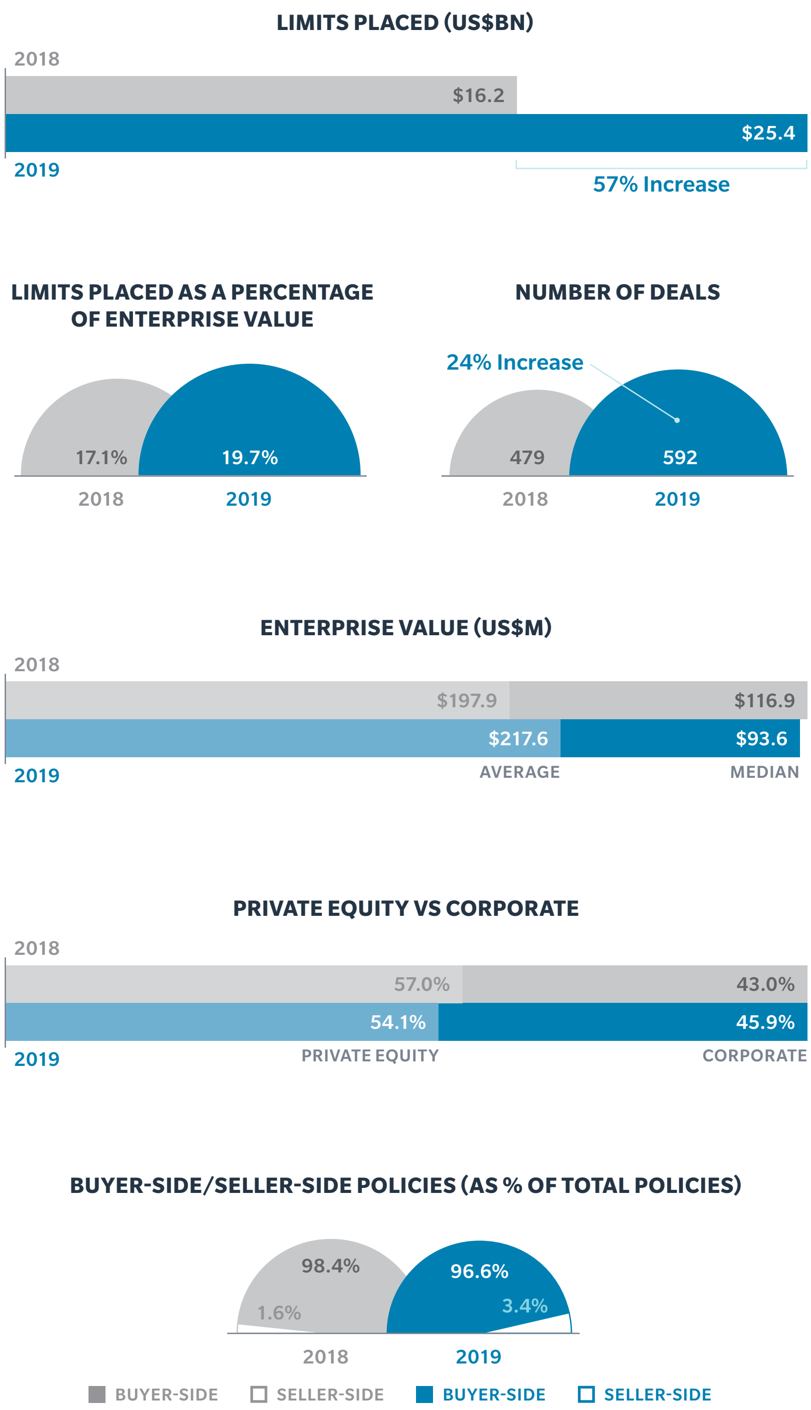
As the average enterprise value of transactions insured increased, the average limit purchased was $42.8 million in 2019, compared to $29.9 million in 2018. The region also saw more transactions insured in both the small to midsize enterprises and in the large cap segment (those valued at $1 billion or more).

Premium rates generally remained flat across Europe in 2019, although we are seeing some signs it could firm in 2020. The high level of competition between M&A insurers that has historically led to premium reductions is now instead leading to a broadening of cover under policies.

FIGURE 4

Deal value in EMEA decreased in 2019, though W&I placements increased.

SOURCE: MARSH JLT SPECIALTY



Notable 2019 Trends

Size of deal insured: Our data show both an increase in the average enterprise value of deals insured and a decrease in the median enterprise value. The emergence of, and competition between, specialist insurers focusing on SMEs mean the product is now economical and efficient at the market's lower end. We also have seen W&I insurance used regularly to facilitate transactions at $1 billion and higher — including in excess of $10 billion — evidencing the significant increase in available insurance capacity and insurers' willingness to engage on the largest and most complex transactions. We estimate the maximum capacity available in the European M&A insurance market is now approaching $2 billion for any one transaction.

Insurer innovation: New insurers entering the market have helped drive innovation in the scope of coverage under M&A insurance policies. For example, synthetic coverages have continued to expand the gap between the contractual recourse offered by the seller and the buyer's recourse under the policy. There has also been growth in coverage for risks identified in due diligence — both tax and non-tax risks. This area has seen significant growth, with insurers deploying substantially increased levels of capital and specialist underwriting teams to support a broad range of tax and contingent risks being insured across a range of sectors and jurisdictions. We expect the use of contingent and tax insurance to grow significantly in 2020 in both M&A and non-M&A (such as restructurings) contexts as insurers continue to make significant deployments of capital.

Nil-recourse policies: Deals in which the seller caps its contractual liability at a £1 are now the norm across EMEA. This structure has been common in the UK, the Nordic countries, and Central Europe for a number of years, typically representing an estimated 75% or greater of placements. We now see nil recourse transactions commonly in Southern Europe, Africa, and the Middle East.

Claims: A rapid increase in claims has begun to impact coverage as insurers increase and/or focus underwriting in areas where they have seen claims activity. We have seen multiple claims payments of amounts in excess of $20 million made in 2019. Broadly, claims activity can be summarised as "more notifications, faster settlements, and more payments." (For more detail, see Marsh JLT Specialty's *Transactional Risk Insurance Claims Study, EMEA*.)

Asia

In 2019, M&A across Asia saw a marked increase in the number and size of deals and in insurance limits placed, particularly in Japan and Southeast Asia.

Overall deal count in the region in 2019 was up by 33% over 2018. At the same time, the average limits placed increased by 200% over the prior year. These increases were driven by an 84% rise in average deal size from US$232 million in 2018 to US$426 million in 2019, including more deals valued over US$1 billion than had been seen in previous years.

The average limit purchased as a percentage of enterprise value was 23.5%, which was close to the 20% benchmark seen in the past few years.

Average W&I premium rate across Asia declined from 2.1% in 2018 to 1.6% in 2019 as capacity and competition increased with new market entrants including Chubb, Fusion, and Berkshire Hathaway. There were also more real estate deals in relation to total deal count — close to 20% of Marsh's total Asia deal count — which typically lead to further overall declines in rates and deductibles. It is likely that rates in China and India will continue to reduce, barring unforeseen changes in conditions, while Japan and Korea could see slight reductions. Rates in Southeast Asia appear to have bottomed and may experience some correction in 2020.

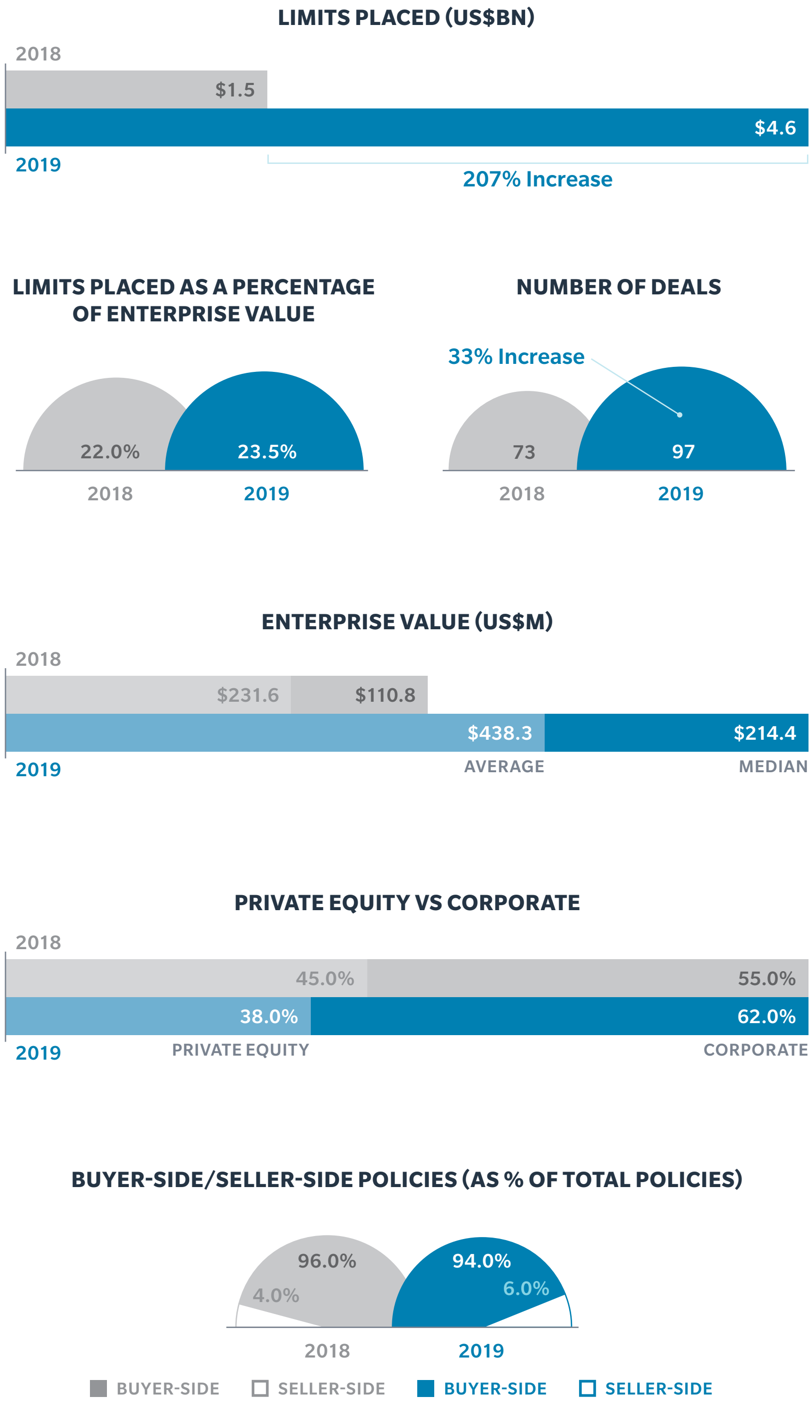
Notable 2019 Trends

Real estate funds: The use of W&I insurance by real estate funds increased in key cities including Singapore, Shanghai, Mumbai, and Tokyo. This helped drive down average premiums and retentions in Asia as real estate deals are priced more competitively, with no retentions in most Tier 1 cities. The real estate sector

FIGURE 5

Deal count and transactional risk insurance limits placed increased in Asia in 2019.

SOURCE: MARSH JLT SPECIALTY



accounted for 20% of the total number of deals done by Marsh JLT Specialty in Asia in 2019, with Singapore leading the way.

Domestic deals: Japan and China experienced growth in the number of domestic deals in 2019. In the past, both countries had been dominated by outbound deals. The tide turned in China largely due to capital controls. As a result, W&I insurance is now being used for a relatively larger proportion of domestic deals and private equity exits. In Japan, W&I insurance had typically been used for outbound deals. This has led to increased familiarity with its use and implementation, and has driven clients to see the value in adopting W&I insurance for their transactional needs on more domestic deals and private equity acquisitions and exits. This has also been partly driven by insurers being more prepared to accept local language due diligence reports and deal documents without full translations being required.

Tax policies: Although the number of tax policies declined in India due to regulation changes, outside of India the number increased, though at a slower pace than in previous years. However, interest is increasing from tax insurers and clients alike in respect of tax risks in Singapore, Malaysia, Korea, and Japan, which could propel a new wave of growth in 2020 and beyond.

Claims: In line with the region's growth in placements, the claims rate increased for the third consecutive year, with 15 notifications filed with insurers in 2019, representing an overall 15.5% rate of claim across all deals. Continuing a trend that began in 2017, tax breaches were the most common form of breach alleged in 2019, amounting to one-third of notifications. Among tax claim notifications, 67% encountered corporate income tax issues, with the rest being share sale tax issues. Most of these claims, however, related to prior years' filings, demonstrating the value that W&I insurance provides in addressing the long-tail nature of tax assessments by the region's tax authorities. From an industry standpoint, the manufacturing, automotive, and retail sectors accounted for 40% of all claims in 2019. For the second consecutive year, real estate deals accounted for the majority of tax-related claims as tax authorities continue to scrutinize companies with property holdings. For more details, see Marsh JLT Specialty's *Insights into W&I Insurance Claims in Asia — What Half a Decade of Data Tells Us*.

Pacific

In 2019, M&A deal value across the Pacific region decreased; however, we saw an increase in the number of W&I insured deals.

Overall, Australian M&A transactions totalled US$58.5 billion in deal value in 2019, the lowest value since 2013. Domestic M&A deal value dropped year-on-year by about 58% to US$21 billion, the smallest annual amount over the last seven years. Inbound deal value fell by 2.3% to US$37.4 billion compared to 2018. Private equity buyouts totalled US$12.4 billion, a 39% decrease in terms of deal value compared to 2018. Private equity exits more than halved in value year-on-year, recording just US$3.2 billion in value across 25 deals.

Despite working on a greater number of transactions in the region in 2019 than in 2018, we placed lower levels of limits. This was due primarily to a sharp decline in the average deal value of W&I-insured deals, to US$187.5 million in 2019 versus US$244.3 million in 2018, a decrease of about 23%. The average limit purchase — as a percent of enterprise value — was 28%, nearly unchanged from the prior year.

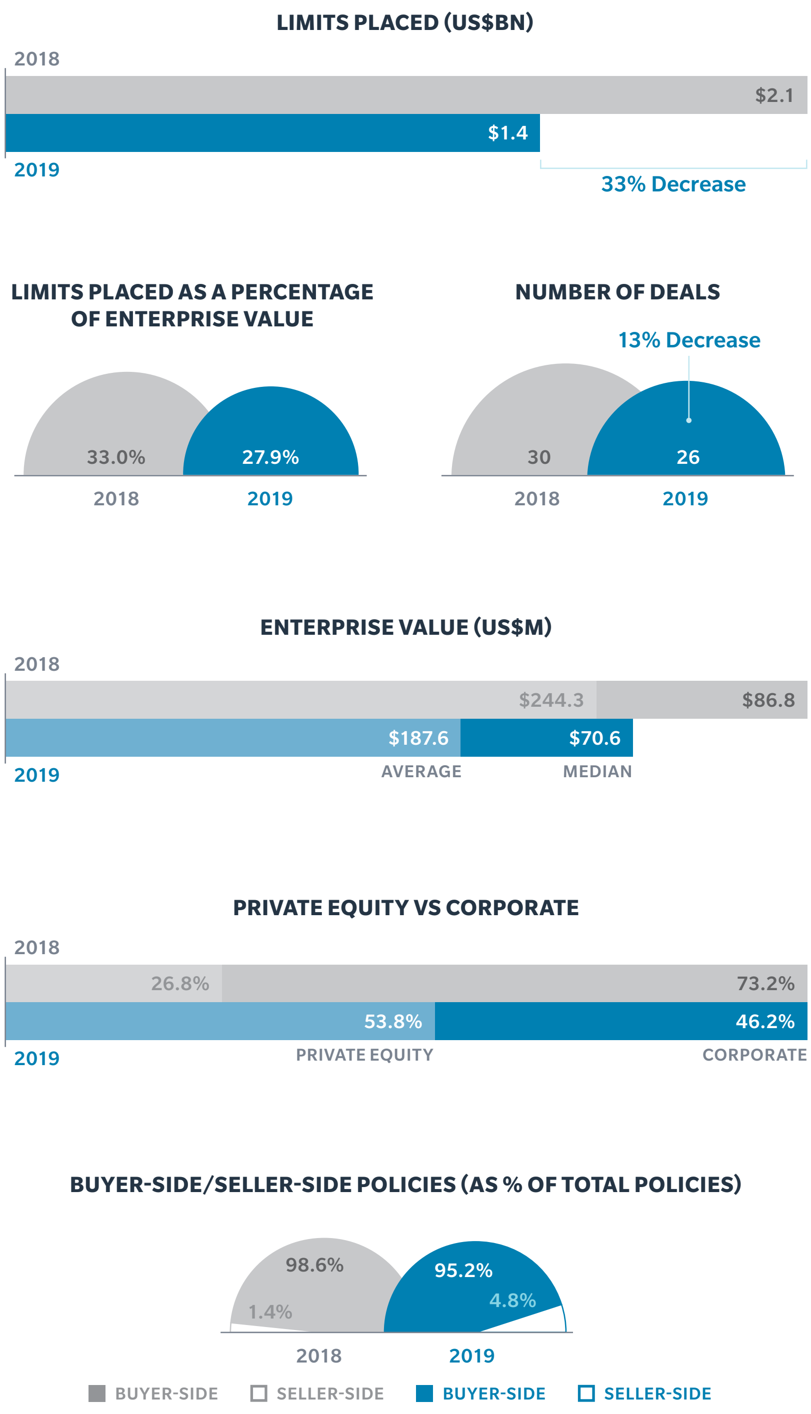
The average premium rate in 2019 declined to 0.96%, down from 1.05% in 2018.

Take up rates of W&I generally remain strong in the Pacific M&A market as the product continues to be an integral tool for Australian and New Zealand dealmakers. Competitive auction processes were the norm in Australia last year, with many transactions taking longer than initially expected.

FIGURE 6

M&A deal value decreased in the Pacific in 2019, though the number of W&I insured deals rose.

SOURCE: MARSH JLT SPECIALTY



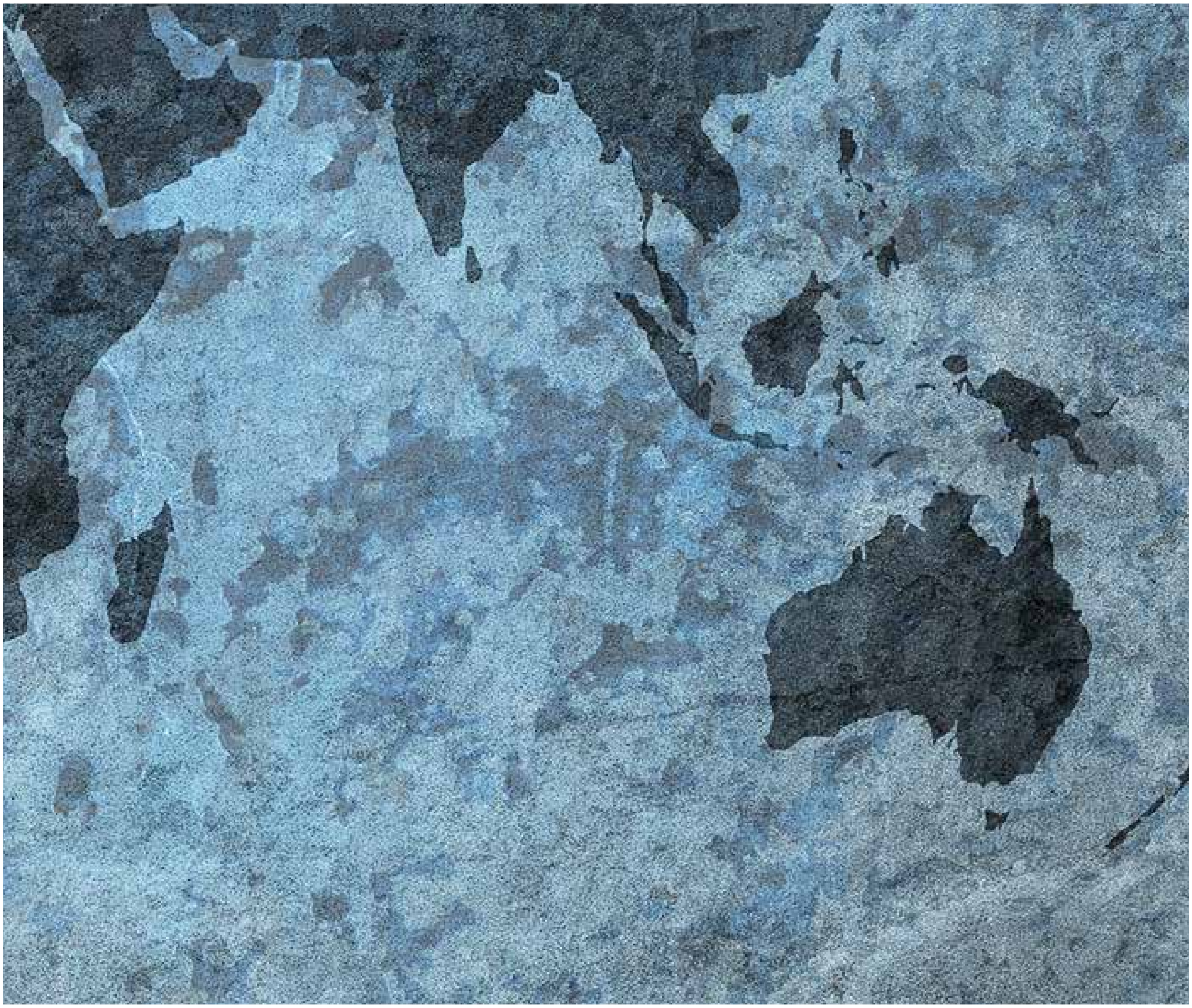
Notable 2019 Trends

"Sell-buy flip": For sellers — private sellers, private equity, and, increasingly, corporates — W&I is now a virtually obligatory deal feature. For buyers, it is generally well understood that W&I will be part of the transaction. Deals that attempt to limit recourse or provide no recourse for buyers are known colloquially as "sell-buy flips." Much of the innovation has been incremental, with an aim toward making the W&I process as efficient and frictionless as possible while ensuring that the winning bidder in an auction scenario is in a position to achieve strong coverage.

Non-traditional risks: In the Pacific W&I marketplace, insurers are increasingly willing to entertain non-traditional risks, such as the use of W&I for public market transactions. Additionally, many insurers have widened their appetite for W&I-adjacent risks, such as tax liability and contingent risk.

Tax policies: Regarding tax liability, the Australian Tax Office has ramped up enforcement efforts, and CFOs, accountants, and tax advisors are increasingly concerned with tax issues. In response, we have a newly established team to support clients and centers of influence that are increasingly searching for more effective ways to mitigate tax risk.

Claims: In 2019 there was a large increase in both the number of claims notifications, and the total quantum of those claims, a change in what had historically been a benign claims environment in the Pacific region. This can be viewed as a positive development in this mature marketplace as the successful resolution of these claims will serve to demonstrate the efficacy of W&I as a transactional tool.



Conclusion

Transactional risk insurance continues to be a firmly established deal solution in the M&A marketplace. In 2019 we saw an expanded use of transactional risk solutions among both smaller enterprises as well as in some of the largest deals. Market capacity can now support limits in excess of US$1 billion. Underwriting processes around transactional risk insurance have become highly refined and move at typical deal cadence, or can be accelerated as necessary based on deal timing.

While the broader insurance market is in a period of transition, with pricing firming in many areas, competition among insurers has kept transactional risk pricing in a generally favorable zone for most buyers. Overall capacity expansion is likely in 2020, along with modest pressure for rate reductions and continued policy innovation.

Among the trends to watch moving forward are developments in claims. As companies expand their use of transactional risk products, it stands to reason that the number of claims will also increase. As this occurs, underwriting will focus on areas in which insurers see activity. Other transactional risk insurance trends include the ongoing expansion of tax insurance, expanded use in various geographies, and insurer innovation.

ABOUT MARSH

Marsh is the world's leading insurance broker and risk adviser. With over 35,000 colleagues operating in more than 130 countries, Marsh serves commercial and individual clients with data driven risk solutions and advisory services. Marsh is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), the leading global professional services firm in the areas of risk, strategy and people. With annual revenue over US$15 billion and 75,000 colleagues worldwide, MMC helps clients navigate an increasingly dynamic and complex environment through four market-leading firms: Marsh, Guy Carpenter, Mercer, and Oliver Wyman. Follow Marsh on Twitter @MarshGlobal; LinkedIn; Facebook; and YouTube, or subscribe to *BRINK*.

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Marsh JLT Specialty's Private Equity and M&A Services practice develops solutions that help create value for investors throughout the investment lifecycle. Clients include corporations, private equity firms, alternative asset managers, lenders, pension funds, infrastructure funds, and family office investors. Our global team of specialists, spanning every region, has deep expertise in all facets of M&A risk management.

For further information, please contact your local Marsh office or visit our website at marsh.com.